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No. 722

IN THE

Supreme Court of the United States

October Term, 1954

In the Matter
of the
ONONDAGA LITHOLITE COMPANY,
Bankrupt,
No. 27,773
In Bankruptcy

First Trust & Deposit Company,
Respondent,

Receiver of Salt Springs National Bank, Joseph T. Connolly; Anna C. Doyle, Howard T. Yates, George C. Zett, and George A. Langan, as Trustee of Bankrupt's Estate,
Petitioners.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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TO THE HONORABLE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Laurence Sovik, Esq., on behalf of Joseph T. Connolly, receiver of Salt Springs National Bank; Anna C. Doyle, Howard T. Yates, George D. Zett, and George A. Langan, as trustee in bankruptcy of Onondaga Litholite Company, bankrupt, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above entitled action on January 19, 1955.

Opinions Below

The opinion of the Circuit Court of Appeals for the Second Circuit was reported in 218 F. 2d 671. The opinion of the District Court, the opinion of the Referee in Bankruptcy, and the opinion of the Trial Court in the State Court action which were not officially reported, are set forth in the appendix hereto annexed.

Jurisdiction

The judgment sought to be reviewed is dated January 19, 1955 and was entered the same date in the Office of the Clerk of the Court of Appeals for the Second Circuit. Jurisdiction is invoked under Section 1254 (1) of the Judicial Code 28 U. S. C. A., Sec. 1254 (Act June 25, 1948, c. 646, 62 Stat. 928).

Questions Presented

1. Does a bankruptcy court have power to subordinate the claim of a creditor to that of all other creditors as to proceeds made available for distribution consisting of cash recovered by the trustee as damages on behalf of all creditors whose claims are filed and allowed (except the creditor from whom the recovery was made) in a

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State Court action based on a loss of the bankrupts assets through a transfer of bankrupts assets by and to such creditor with the intent to hinder, delay and defraud the other creditors of bankrupt.

2. Has a trustee in bankruptcy the power to sue for money damages, a creditor of the bankrupt who has caused bankrupts' assets to be lost through a transfer intended to hinder, delay and defraud the other creditors of the bankrupt, on behalf only of the creditors who have been damaged by such loss. If so, is the offending creditor entitled nevertheless to participate pro-rata to the extent of its claim with such other creditors in any such recovery of money damages.

Statutes Involved

Bankruptcy Act, Section 2 (11 USCA, Section 11):

"(a) The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction *at law and in equity* as will enable them to exercise original jurisdiction in proceedings under this title, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held, to—". (Emphasis supplied.)

Bankruptcy Act, Section 57 (g) (11 USCA, Section 93 (g):

"The claims of creditors who have received or acquired preferences, liens, conveyances, transfers, assignments or encumbrances, void or voidable under

this Act, shall not be allowed unless such creditors shall surrender such preferences, liens, conveyances, transfers, assignments, or encumbrances."

Facts

On or about July 16, 1951, petitioner Langan, as trustee in bankruptcy of Onondaga Litholite Company (hereinafter called bankrupt), recovered $55,536.99 from respondent, First Trust & Deposit Company (hereinafter called Bank), in satisfaction of a judgment recovered against the bank and Demark Corp. (hereinafter called vehicle of the bank) and others at the conclusion of litigation in the New York State Courts extending over a ten-year period. Said $55,536.99 constitutes the only asset of the bankrupt, with the exception of $309.75, available for distribution among bankrupt's creditors. The referee in bankruptcy and the District Court allowed Bank's claim in the amount of $616,233.23 but subordinated said claim to the claims of all other creditors duly filed and allowed in the face amount of $201,210.46.

The said recovery of $55,536.99 from the Bank and the subordination of the bank's claim to that of the other creditors was based upon the following facts and circumstances:

Organized in 1901, bankrupt for the first twelve years of its existence was engaged in the business of building sidewalks. From 1912 to 1938, bankrupt was engaged in the manufacture and sale of cast stone made from marble, granite and black slag and used extensively throughout the United States in the construction of large buildings.

In July of 1938 bankrupt had a large manufacturing

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plant, located at Syracuse, N. Y., consisting of a three-story office building constructed with its own product, carpentry shop and the manufacturing plant proper, a large structure about the length of two average business blocks, housing machinery and equipment used to manufacture bankrupt's product. This equipment, consisted of conveyors, cranes, derricks, stone crushing and cement mixing equipment which were standard and could be used for a wide variety of purposes.

During 1938 the bankrupt's land and buildings were assessed by the City of Syracuse for $118,000.00 for real property taxes. During the foreclosure proceedings hereinafter described, the Bank loaned bankrupt's receiver, appointed in the foreclosure proceeding, $2,375.00 to pay premiums on fire insurance policies on the buildings of bankrupt located in Syracuse in the amount of $223,000.00 under policies of insurance requiring that the buildings to be insured up to 90% of their value.

In July of 1938 bankrupt also had between 500 and 600 secret formulas used in its business. Bankrupt, in July 1938, also had, as found in the State Court action, raw materials and work in process of a fair market value of $75,000.00 and a sales sample inventory of a fair market value of $21,000.00.

In July of 1938 the Bank had claims against bankrupt totaling $[illegible]. Of this amount $105,000.00 represented the amount due on bankrupt's three-year 6% unsecured Series B debentures due June 1, 1935. The balance of the indebtedness represented loans made by the Bank to bankrupt from time to time.

In July 1938 the Bank also owned all of the bonds (except $100.00) totalling $18,900.00 secured by a first mortgage on all of bankrupt's real property, machinery, equipment and fixtures. The trustee under said bond issue the Utica Trust Company, in July 1938 held a cash sinking fund deposit in the amount of $10,478.00, leaving a balance due on said mortgage bonds of $8,422.00 with interest from July 1, 1932.

For many years prior to its adjudication in bankruptcy the Bank was in complete control of bankrupt through a voting trust agreement in which the majority of the capital stock of bankrupt was deposited with voting trustees controlled by the bank.

From Feb. 11, 1937 to Nov. 19, 1938 the Board of Directors of bankrupt consisted of six directors all controlled by the bank. An Executive Committee of the directors also in control of the bank was in active charge of bankrupt's affairs.

The Court in the State Court action found:

> "On February 6, 1937 a voting trust agreement was made (Exh. 41) vesting voting power control of bankrupt's common stock in defendants Sandford and Eddy and one William J. Bourke, *in order to place the bank in control of bankrupt.*" (Emphasis supplied).

Also:

> "From Ferbuary 11, 1937 to July of 1938 the business and affairs of bankrupt were managed and controlled by the officers, directors and employees of the bank."

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The Trial Court in the State Court action describing the control exercised by the Bank over bankrupt, stated:

> "The proof as tabulated in the diagram shows that the Executive Committee of five had as its majority or working control two directors and an officer of the Bank; that the board of six directors which appointed this Executive Committee found three of its membership in a Bank Officer and two attorneys for the Bank who also acted as attorneys for the Company; and a fourth member, Sehl, was an accountant regularly used by the Bank; further that a voting trust agreement made possible the perpetuation of this concontrol. For the exercise of control of the Company by the Bank the interlocking seems entirely adequate and complete. Under these circumstances the situation of each of the interlocking personnel became delicate indeed."

In March of 1938 bankrupt's borrowings from Bank had reached the loan limit allowed by New York State Banking Law and shortly thereafter Mr. Merrill, President of the Bank and a member of Bankrupt's Executive Committee of its directors and Mr. Cowie, one of the attorneys for the Bank, called upon the Utica Trust Company, as trustee of the trust indenture securing the first mortgage bonds and demanded that they foreclose the mortgage which was a first lien on bankrupt's real property, machinery and equipment in order to pave the way for the bank to seize all of bankrupt's assets.

On July 22, 1938, Richard F. Harrison (also a member of bankrupt's Executive Committee), as Executive Vice President of the Bank, executed a formal demand which

in effect required the Utica Trust Company to take immediate steps to foreclose said mortgage.

Joseph P. Rogers (a director of bankrupt), and one of the attorneys for the bank, prepared the necessary papers to foreclose said trust mortgage and took the necessary steps to complete the same.

No request was made by the officers of the Bank or their attorneys serving on the Board of Directors or Executive Committee of bankrupt to the Utica Trust Company, as trustee, for an extension of time to pay the balance due on the bonds secured by the trust mortgage, nor was any attempt made to make other arrangements to avoid or preclude said foreclosure proceeding but on the contrary said persons did everything possible to insure that the foreclosure proceeding was carried through to its conclusion secretly. It was found as a fact in the State Court action that:

> "The bank knew that no one would benefit by the foreclosure except the bank."

All of bankrupt's accounts receivables were pledged with the Bank as security for its loans.

It was also found in the State Court action that the defendants in that action knew that there were no assets from which the claims of other creditors, bondholders and stockholders could be paid except out of the equity in bankrupt's assets subject to the lien of the trust indenture.

No meeting of directors or stockholders was held to consider the matter of the foreclosure and it was found as a fact in the State Court action that although the officers and attorneys of the bank serving on the Board of Directors and Executive Committee of the bankrupt knew of

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the steps taken to procure the foreclosure of the mortgage, they did not discuss the matter with other officers or directors of bankrupt.

In July or August of 1938, Richard F. Harrison (a member of bankrupt's Executive Committee), Executive Vice President of the Bank, issued instructions to bankrupt's employes to close down the plant and cancel all contracts. The Bank's loan limit had then been reached. Between the commencement of the foreclosure action and the foreclosure sale, the Bank transferred to Domark Corporation, which it used as a vehicle, all of the bankrupt's first mortgage bonds owned by the Bank.

In the State Court action it was found that

> "No other attempt was made by the defendants to interest any person in the purchase of said assets to be sold under said foreclosure sale."

Concerning the foreclosure sale, the Court in the State Court action found as facts:

> "Such persons as did make inquiries with regard to said foreclosure sale were sidetracked and not encouraged."
>
> "No other advertisements of said foreclosure sale were placed in any paper, trade or mechanical journals."

The notice of foreclosure sale provided that everything be sold as a unit and prospective bidders were required to deposit $5,000.00 in cash or certified check prior to bidding. The bank and bankrupts' officers and directors Merrill, Harrison, Sandford, Rogers and Yeomans knew at the time of the sale that no other bidders would be at the sale. No bidders attended the foreclosure sale except

the attorney for the bank and the Domark Corporation, the vehicle of the bank, which bid in the mortgaged premises and all of the assets sold at $25,000.00.

The foreclosure sale was in no way brought to the notice of the stockholders of the company or the creditors, other than the bank.

The Trial Court in the State Court action in its Findings and decision thus described the foreclosure sale:

> "The foreclosure and sale of bankrupt's assets was commenced and consummated for the purpose as presumed in law of transferring the real property, buildings, machinery, equipment, fixtures and other property described in the mortgage foreclosed to the defendants, First Trust & Deposit Company, and Domark Corporation to hinder, delay and defraud *other creditors* of bankrupt.
>
> Bankrupt, while insolvent, through defendants Broga, Harrison, Sandford, Merrill, Sehl, Eddy, Rogers and Yeomans, officers and directors of bankrupt, voluntarily transferred without consideration the real property, buildings, machinery, equipment, fixtures and other property described in said mortgage, to the defendants First Trust & Deposit Company and Domark Corporation with intent as presumed in law to hinder, delay and defraud *other creditors* of bankrupt." Fol. 219, 302 N. Y. 932.
>
> * * * * *
>
> "The foreclosure was a transparent use of legal machinery with a gossamer-thin appearance of regularity but *without opportunity of any kind to the real parties in interest (to whom they owed a fiduciary obligation) to protect themselves.* In this the direc-

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tors not only failed affirmatively to protect those to whom they owed a duty but became parties to a program in the nature of a conspiracy of silence and concealment which caused serious damage.

By these means the Bank through a controlled Board of Directors and a controlled Executive Committee secured for a consideration of $25,000.00, the mortgaged assets of the Company which were worth much more.

This constitutes something other than a mere preference. There was a plan for an ostensible legal sale so brought about that other creditors would not learn of it and this is confirmed by the failure to encourage interest on the part of casual inquiries as indicated by the correspondence. Such an attitude either avoided or forestalled other bids. The entire foreclosure and transfer by Referee had no greater effect or validity than a direct conveyance by officers of the Company thereto empowered by this controlled Board of Directors, to the Domark Corporation." (Emphasis supplied).

On May 16, 1939 as directors and officers of bankrupt, Sandford, Eddy, Rogers, Brega and Yeomans executed and filed a voluntary petition in the Supreme Court of Onondaga County to dissolve bankrupt. Certain creditors of bankrupt, having received notice of this dissolution proceeding, filed an involuntary petition in bankruptcy against bankrupt, alleging as an act of bankruptcy that said foreclosure proceedings were commenced and prosecuted for the purpose of hindering, delaying and defrauding the other creditors of bankrupt. No answer to said involuntary petition was filed by bankrupt and on July 17, 1939 it was duly adjudicated a bankrupt. Claims

against bankrupt totaling $201,210.00, exclusive of claims held by the Bank and Domark Corporation, were duly filed and allowed in the bankruptcy proceeding.

The plant, equipment and business of bankrupt being no longer intact and having piece meal been disposed of by the bank, Petitioner as trustee in bankruptcy commenced an action against the bank, its vehicle, the Domark Corp. and Merrill, Harrison, Sandford, Rogers, Yeomans and others to recover damages sustained by the other creditors as a result of the transfer of bankrupt's property by means of the foreclosure device to the bank and Domark Corporation.

Upon the first trial Petitioners complaint was dismissed at the conclusion of his case. On appeal this dismissal was affirmed, 266 App. Div. (N. Y.) 1056. The Court of Appeals, 293 N. Y. 604, reversed and ordered a new trial.

Upon the second trial the Trial Court awarded damages in favor of these creditors who had been defrauded by the bank in the amount of $60,000.00 with interest theron from August 1, 1938, plus costs, making a total $102,747.11 in all. Upon appeal (277 App. Div. 1090) the judgment was modified by reducing the amount of these damages to $29,850.00 with interest in the amount of $21,551.70, plus costs, making a total of $53,348.65. Upon appeal to the Court of Appeals this judgment was affirmed (302 N. Y. 932).

The Bank in proceedings before the Referee in Bankruptcy claims that it is entitled to its pro-rata share of this fund recovered admittedly as damages on behalf of all the creditors of bankrupt whose claims have been filed and allowed except, the Bank.

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The referee and the district Court on review held that the Bank was not entitled to participate because admittedly the recovery was damages only for the creditors *except* the bank and further that in any event the banks claim should be subordinated to all other claims.

On appeal the Second Circuit Court of Appeals has held:

1. That the referee and the District Court had no power to subordinate the banks claim.
2. That the trustee had no power to sue the bank for damages on behalf of the creditors of bankrupt whose claims had been filed and allowed exclusive of the bank.

ARGUMENT

The Second Circuit has decided a Federal question in a way in conflict with the applicable decisions of this Court.

I. Subordination was properly directed by the District Court under the applicable decisions of this Court.

The Second Circuit has imposed an apparent restriction on the power of the District Court, sitting as a Court of Bankruptcy, to subordinate, in the exercise of its broad equitable powers the claim of a creditor who has been found guilty of transferring bankrupts assets to hinder, delay and defraud other creditors.

The Second Circuit has treated the provisions of Section 57g of the Bankruptcy Act (11 U. S. C. A., Sec. 93g) as requiring inexorably that the claim of a creditor who obtains assets through a fraudulent transfer, void or voidable under the Bankruptcy Act be allowed to participate without subordination where the property thus acquired is ultimately returned to the custody of the Bankruptcy Court even though equitable considerations would dictate that the claim be subordinated. This is demonstrated by the Second Circuit's failure to refer to the equitable considerations which moved the District Court to uphold the Referee's order of subordination, except that the Court in the final paragraph of its opinion did refer to the fact that the State Court action as originally instituted was brought solely for the benefit of the creditors of the bankrupt other than the Bank.

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The action was so brought because the trustee could not recover the assets so transferred. They being lost, he sued for and recovered money damages for the creditors who were damaged, to the extent of their damage.

Entirely ignored by the Second Circuit were the equitable considerations which convinced the Referee in Bankruptcy and the District Court that principles of equity firmly rooted in the Law of Bankruptcy demanded that the claims of the Bank be subordinated to the claims of the other creditors.

First: That the recovery by the trustee was had after extensive litigation over an eleven-year period which was admittedly carried on during that entire period for the benefit of all the creditors except the Bank, to the extent of the damages sustained by them.

Second: The District Court recognized that the bank dominated and controlled the bankrupt and stated in its opinion:

> "In fact, it does not seem to be disputed but that the bankrupt was controlled by the Bank and that Domark was in effect the Bank. Such a situation requires rigid adherance to the rules of fair play."

The Trial Court in the State Court litigation had previously held that the action of the bank, its officers and its attorneys, while in control of the bankrupt, "constitutes something other than a preference" (302 N. Y. 932, Fol. 412). The Bank had caused a loss of bankrupt's assets by their fraudulent transfer.

The State Court correctly held that the action of the bank and its officers and attorneys while controlling the

bankrupt and the acquisition of the bankrupt's plant, machinery and equipment was something other than a preference. This was not an instance of a creditor of an insolvent debtor merely procuring as best it could in competition with other creditors, a preference or conveyance void or voidable under the Bankruptcy Act. Rather, it was a flagrant example of fiduciaries (officers and attorneys of the bank serving as directors and members of the Executive Committee of the bankrupt) directing the destines of a financially troubled corporation in violation of the fiduciary duties and obligations owed to *all* of the creditors of the bankrupt. The controlling directors of the bankrupt denuded the assets of the bankrupt for the benefit of the Bank to the pronounced detriment of the other creditors. Further, and most significant, it must be borne in mind that the property taken for the bank—a manufacturing plant with its machinery and equipment—rendered it certain that other creditors of the bankrupt would not be able to obtain any payment whatever on their claims either from the bankrupt's equity in its property or from future operations.

The bank did obtain a preference, but that is only one side of the coin. This fraudulent transfer was conceived, made possible and brought to fruition by fidciaries violating the duties of loyalty, fairness and impartiality owed to all of the creditors of bankrupt. Before this fraudulent transfer was obtained, fiduciary duties and obligations were ignored. The District Court found in the violation of these fiduciary obligations on the part of those controlling an insolvent corporation, and the damages flowing therefrom, sufficient to require the subordination of the claim of the creditor whose executive officers and attor-

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neys were parties to the betrayal of the interests of the other creditors whose clear duty it was to protect.

The decision of the Second Circuit would apparently afford to all fraudulent transferees the right to share ratably in a dividend distribution even though the transfer resulted from the violation of fiduciary obligations owed by the fraudulent transferee to the other creditors, not in its capacity as such transferee but in its capacity, through its executive officers and attorneys, as master of an insolvent debtor.

The Court below has cited *Keppel* v. *Tiffin Savings Bank* (1905), 197 U. S. 356, and *Page* v. *Rogers*, (1909), 211 U. S. 575, as requiring that the bank be permitted to participate in the dividend distribution without subordination of its claim. However, in neither the *Keppel* case nor the *Page* case, *supra*, did the transferee dominate the debtor and as a result owe the duties and obligations of a fiduciary to the other creditors of the debtor. In the *Keppel* case, *supra*, this Court pointedly referred to a finding that the transferee "acted in good faith, without knowledge of the insolvency of its debtor and of wrongful intent on its part".

There was thus no fraud involved in the *Keppel* case.

The instant case presents a far different factual situation, for the executive officers of the bank knew of the bankrupt's insolvency and arranged the foreclosure proceeding to benefit the bank and to defraud the other creditors.

The equitable principles which this Court enunciated thirty-four years later in *Pepper* v. *Litton* (1939), 308 U.

S. 295, and which the District Court applied in the instant case, would seem to justify, if not require, the subordination of the bank's claim.

In the *Pepper* case, *supra*, this Court pointed out that if under Section 57k of the Bankruptcy Act "a claim which has been allowed may be later rejected in whole or in part according to the equities of the case, disallowance or subordination in light of equitable considerations may originally be made."

In the *Pepper* case this Court stated:

> "In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder."

The District Court obeyed the mandate of this Court in the *Pepper* case and did sift the circumstances surrounding the claim of the bank. In the bank's acquisition of bankrupt's property in fraud of the other creditors at a time when the bank was in complete cotnrol of bankrupt, the District Court found in the violation of the fiduciary obligations owed to all of the creditors, with the resulting advantage to the bank and damage to the other creditors, a set of circumstances where, in the words of this Court in *Pepper* v. *Litton*, *supra*, "The necessity of equitable relief against that fraud becomes insistent."

Furthermore it is equally if not more so inequitable to now permit the bank to share ratably in a recovery had by the trustee exclusively for the benefit of the other creditors.

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The following expression of this Court in the *Pepper* case, pertaining to the responsibility and fiduciary obligations owed by those controlling the destines of an insolvent corporation with resultant subordination of their claims for failure to discharge their fiduciary obligations, is singularly appropriate to the action taken by the bank's executive officers and attorneys controlling the bankrupt:

> "But in that situation as well as in the others to which we have referred, a sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors. He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. *For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion*

or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation." (Emphasis supplied).

The decision of the Second Circuit cannot be reconciled with other decisions of this Court where subordination has been directed in the exercise of equitable considerations. In *Prudence Realization Corp.* v. *Geist*, 316 U. S. 89, this Court stated:

> "It is for that Court (the Bankruptcy Court)—not without appropriate regard for rights acquired under rules of State law—to define and apply Federal law in determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy requires its subordination to other claims which, in other respects, are of the same class."

In *Sampsell* v. *Imperial Paper & Color Corp.*, 313 U. S. 215, one Downey who had conducted a business as a sole proprietor, formed a corporation controlled by himself and his family and transferred his stock of goods to the corporation at a time when he had extensive debts. Downey was subsequently adjudicated a bankrupt. Respondent extended credit to Downey's corporation after its organization. The Referee found that the corporation was formed for the purpose of hindering, delaying and defrauding Downey's creditors and he accordingly ordered that the property of the corporation was the property of Downey's individual bankrupt estate and that it be administered for the benefit of the creditors of Downey's individual bankrupt estate. The Referee further found that

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respondent, with knowledge of Downey's indebtedness, was instrumental in getting Downey to form the corporation and had full knowledge of its fraudulent character.

Respondent as a creditor of the corporation claimed a prior right to distribution of the funds in the hands of the trustee received from the liquidation of the assets of the corporation. Respondent thus invoked the familiar rule that ordinarily creditors of the corporation would be entitled to satisfy their claims out of corporate assets prior to any participation by the creditors of the individual shareholder. This Court declined to apply the ordinary rule which would have afforded respondent a priority in the distribution of the corporation's assets stating:

> "Such priority, however, would be denied if the corporation's creditors were parties to a fraudulent transfer of the stockholder's assets to the corporation."

The Court then proceeded to reaffirm the principle that:

> "The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete. Taylor v. Standard Gas & E. Co. 306 US 307, 83 L ed 669, 50 S Ct 543, 38 Am Bankr Rep (NS) 692; Pepper v. Litton, 308 US 295, 84 L ed 281, 60 S Ct 238, 41 Am Bankr Rep (NS) 279; Bird & Sons Sales Corp. v. Tobin (CCA 8th) 78 F (2d) 371, 100 ALR 654, 29 Am Bankr Rep (NS) 171."

Just as equitable considerations demanded in *Sampsell* v. *Imperial Paper & Color Corp.*, *supra*, that the creditor be denied a priority which it would otherwise have been entitled to, so in the case at bar equitable considerations

demand that the bank's claim be suborinated when to afford the bank a parity with the other creditors in any distribution from the bankrupt's estate would condone a flagrant breach of fiduciary obligations and duties which stripped the bankrupt of its plant and machinery and resulted in the bank obtaining property of the bankrupt to the exclusion of the other creditors.

In *Union Central Life Insurance Co.* v. *Drake*, 214 F. 536, the Eighth Circuit indicated that despite the rule of *Keppel* v. *Tiffin Savings Bank*, 197 U. S. 356, inequitable conduct could deprive a creditor of the equality of distribution which was afforded the creditor in *Keppell* v. *Tiffin Savings Bank*, *supra*.

This clearly is a case for the application of this rule.

In *In re Sherk*, N. D. Ohio, 108 F. Supp. 144, the Court denied a fraudulent transferee the right to invoke Section 57(g) of the Bankruptcy Act, where the fraudulent transferee had resisted the trustee's attempt to recover the bankrupt's property, rendering litigation necessary. This decision is in harmony with this Court's recent pronouncements pertaining to the subordination of claims where a creditor has been guilty of inequitable conduct.

In *Hanssen* vs. *Wingren*, 121 F 2d, 1011, cert. den. 314 U. S. 683, certain creditors were given a lien on the company's assets in proceedings for the reorganization of the company under Section 77 (b) of the Bankruptcy Act. This plan was consummated in part. More than two and one-half years after confirmation of the plan, the debtor was adjudicated a bankrupt. The Referee in Bankruptcy and the District Court ruled that the Order confirming the plan was of no binding force in bankruptcy and refused to

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recognize the lien and priority awarded said creditors under the plan and relegated them to the position of general unsecured creditors. The Court of Appeals for the Tenth Circuit reversed, stating that said creditors lost, or may have lost, valuable rights by their acceptance of the plan of reorganization and its partial consummation extending over a period of nearly three years. In the meantime, there was a shrinkage in the debtor's assets through sales and use of the proceeds to pay various claims. The Court held that, under the circumstances, equitable considerations required that the claims of other creditors be subordinated to the creditors previously given a lien on the company's assets in the reorganization proceedings. The Court stated:

> "Because of equitable considerations, the Court of Bankruptcy may disallow or subordinate a claim which in equity and good conscience should not be allowed or paid on a parity with other claims."

Such considerations are clearly present in the case at bar. The Circuit Court of Appeals erred in disregarding them.

II. Under the circumstances here disclosed the trustee had a right to institute an action the recovery in which would inure for the benefit of all creditors except the fraudulent transferee.

The District Court stated in its decision:

> There is no doubt but that the action was brought and tried upon the theory that the recovery would be for the benefit of creditors, exclusive of the First Bank and Domark. The pleadings, the briefs, the

trial Judge's findings, conclusions and opinion, all lead to that conclusion.

The Circuit Court recognized in its opinion "That the State Court action, as originally instituted, purported to be brought solely for creditors other than appellant." However, it regarded this fact as of no consequence. Even if the action had not been brought for the benefit of all creditors of bankrupt, with the exception of the Bank and Domark Corporation, it would not follow that all creditors of bankrupt had an indiscriminate right to share in the proceeds of the recovery. Equitable considerations could, under the decisions of this Court (*Pepper* v. *Litton*, 308 U. S. 295; *Sampsell* v. *Imperial Paper Corp.*, 313 U. S. 215; *Taylor* v. *Standard Gas and E. Co.*, 306 U. S. 307; *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89) require the subordination of claims of a creditor where the creditor's conduct has been inequitable.

In *Gochenour* v. *Cleveland Terminals Building Co.*, 118 F 2d 89, 93, the Sixth Circuit stated:

> "We think it is reasonably clear that the causes of action which appellants' class suits sought to maintain passed under the control of the court in these proceedings and this is true, *notwithstanding the fact that some of the creditors of the corporation may have participated in the alleged fraud and would not be entitled to share in any recovery.* Henderson v. Binkley Coal Company, 7 Cir., 74 F. 2d 567; McCollum v. Hamilton National Bank, 303 U. S. 245, 247, 58 St. Ct. 568, 82 L. Ed. 819; In re Bothe, 8 Cir., 173 F. 597." (Emphasis supplied).

The State Court litigation had been conducted for ten years upon the theory that any recovery therein was for

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the sole benefit of the creditors of the bankrupt other than the bank and Domark Corporation. Petitioner's complaint in the State Court action alleged:

> "That said transfers were in violation of the provisions of the General Corporation Law of the State of New York and by reason of said illegal transfers the assets of Bankrupt have been lost, wasted and misappropriated through their neglect and their failure to perform their duties as officers and directors of Bankrupt; that said assets constituted the sole capital of Bankrupt available to payment of creditors, particularly said petitioning creditors and said other creditors, and said creditors were in existence at the time of said unlawful acts and still remain unpaid; *that by reason of said illegal transfers said other creditors* and particularly said petitioning creditors have suffered damage in the amount of their claims, as aforesaid, to-wit $201,210.46.
>
> WHEREFORE, Plaintiff demands judgment against defendants in the sum of $201,210.46, together with reasonable attorneys' fees as are allowed by law, besides the costs and disbursements of this action, and for such other and further relief as may be just and equitable in the premises."

Domark Corporation (the bank for purposes of this case) in the State Court action interposed the following defense and counterclaim:

> "That the defendant Domark Corporation, under Section 68 of the Bankruptcy Act of 1938, claims the right and offers to set off to the plaintiff, out of said sums of money due to the defendant, so much as will be sufficient to satisfy the plaintiff's damages, if any, in respect to the alleged matters complained of."

Domark Corporation further pleaded in its answer to the State Court action "for a fourth defense to the Plaintiff's complaint and as a counterclaim":

> "12. That it is a creditor of Onondaga Litholite Company, bankrupt, in an amount exceeding Four Hundred Fifty-three Thousand Four Hundred Ninety-four Dollars and Seventy-three Cents ($453,494.73) and has duly filed its verified claim for such amount in the bankruptcy proceedings of said Onondaga Litholite Company, bankrupt; that in the event of recovery by the plaintiff herein, the said defendant claims its pro rata share of any dividend arising therefrom and payable to the creditors of said bankrupt by the plaintiff in said bankruptcy proceedings."

The right of setoff and counterclaim of Domark Corp. was not urged at the trial. No proposed Findings of Fact or Conclusions of Law were submitted on behalf of Domark Corporation and judgment was rendered against Domark as well as the Bank and the other defendants. Domark also appealed to the Appellate Division and there attempted to raise the issue of this offset and counterclaim unsuccessfully. (Domark Brief, pp. 5-7, 277 App. Div. 1090).

As Point III of its brief in the Appellate Division in the second trial, Domark urged: "This appellant should be granted the right to a dividend in the bankruptcy of Onondaga Litholite Company on the basis of its claim after deducting therefrom the amount necessary to offset respondent's damages, if any." As Point V of its brief in the Appellate Division, Domark urged: "The judgment appealed from should be reversed or in the alternative

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modified to provide this appellant the relief requested in the foregoing points of this brief."

The order of the Appellate Division did not reverse the judgment of the trial court nor did it award to Domark the relief requested under Point III and Point V of its brief. No appeal was taken by Domark Corporation from the order of the Appellate Division or the judgment entered thereon.

The opinion of the Trial Court makes it clear that the State Court litigation was predicated upon the theory that any recovery against the bank would enure exclusively to the benefit of the creditors of bankrupt other than the Bank and Domark Corporation. The Trial Court in its opinion stated:

> "The question remains, what damage was suffered by and should be awarded *to those represented by the plaintiff Trustee in Bankruptcy in this action, the petitioning creditors in Bankruptcy and the other creditors exclusive of defendants First Trust & Deposit Company and Domark Corporation.*" (Emphasis supplied).

Domark Corp. upon its appeal to the Appellate Division of the judgment entered at the conclusion of the second trial, urged that it "be granted the right to a dividend * * * on the basis of its claim after deducting therefrom the amount necessary to offset respondent's (petitioner's) damages, if any." At that time Domark Corp. was the owner and holder of the claims which the bank previously had against bankrupt totaling $470,854.81, having acquired the same from the bank prior to the fraudulent transfer. The order of the Appellate Division did not grant to Domark Corp. the right to a dividend in the bank-

ruptcy proceeding and no appeal was taken by Domark Corporation from the order of the Appellate Division or the judgment entered thereon. Said order and judgment were entered Nov. 15, 1950, and Dec. 12, 1950, respectively. On Jan. 3, 1951, the bank reacquired the claims which it had previously transferred to Domark Corporation and which were pleaded by Domark Corp. as a defense and counterclaim in the State Court action.

III. The instant decision and a decision subsequently rendered (Gannett Co., Inc., v. Larry, decided March 31, 1955) have produced confusion within the Second Circuit regarding the power of a Bankruptcy Court to subordinate claims in the exercise of its equitable jurisdiction. The two decisions, when read together, demonstrate that in the instant case the Court below has so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision.

In the case at bar, decided January 19, 1955, the Second Circuit denied the power of the District Court to subordinate a claim based on equitable considerations. On March 31, 1955, the same Court upheld a subordination based on equitable considerations.

In *Gannett Co., Inc.* v. *Larry, Trustee in Bankruptcy of Berwin Paper Manufacturing Corporation, Supra*, the Court found sufficient justification for the subordination of all the claims of a newspaper publisher totaling in excess of $590,000.00 owed by bankrupt, a paper manufacturer, in the fact that the newspaper publisher controlled the debtor and utilized it in part to manufacture news-

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print, a product bankrupt had never manufactured previously, at a time when the newspaper publisher was having difficulty in obtaining newsprint which was then in short supply. The Second Circuit stated in its opinion:

> "* * * the fact remains that the losses suffered by Berwin were suffered, not in an attempt by Gannett primarily to make the subsidiary a financially profitable proposition, but to turn it into a source of newsprint, of no interest to the other creditors—unless financially profitable—but of distinct interest to Gannett, whether or not financially profitable, because of Gannett's newsprint shortage."

In the *Gannett* case, *supra*, there was a stipulation that there was no fraud whatsoever on the part of the newspaper publisher.

In the *Gannett* case *supra*, the Court affirmed an order of subordination where the creditor controlling the bankrupt had merely used it to manufacture a product not previously manufactured by the bankrupt which could be used by the controlling creditor to its advantage, it being conceded that the creditor's conduct was not fraudulent. In the case at bar, on the other hand, the Second Circuit reversed a subordination order subordinating the claim of a creditor controlling the bankrupt which had fraudulently transferred the bankrupt's manufacturing plant and equipment to itself. If inequitable conduct, or the possibility thereof, justifying subordination was found in the Gannett case *supra*, one searches in vain for reasons justifying the reversal of the subordination order in the case at bar.

CONCLUSION

It is therefore respectfully submitted that for the reasons above stated this petition for a writ of certiorari should be granted.

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APPENDIX

OPINION OF THE CIRCUIT COURT OF APPEALS.

UNITED STATES COURT OF APPEALS
For the Second Circuit

No. 144 October Term, 1954
Argued December 14, 1954 Decided January 19, 1955
Docket No. 23069

In the Matter of the ONONDAGA LITHOLITE COMPANY,
Bankrupt.

First Trust and Deposit Company,
Appellant,

Receiver of Salt Springs National Bank, Joseph T. Connolly; Anna C. Doyle, Howard T. Yates, George D. Zett, and George A. Langan, as Trustee of Bankrupt's Estate,
Appellees,

Before SWAN, FRANK and HINCKS,
Circuit Judges.

HINCKS, Circuit Judge.

This appeal is brought by the First Trust and Deposit Company, a creditor of the bankrupt Onondaga Litholite Company, from an order of the Bankruptcy Court subordinating its claim to those of all other creditors. The

trustee in bankruptcy and certain creditors are the appellees.

The facts are as follows: the appellant had loaned the Onondaga, prior to its adjudication, a substantial sum much needed by Onondaga as working capital. Thereafter, when Onondaga was unable to meet this and other obligations, the appellant and another bank became voting trustees of Onondaga. The appellant also owned $18,900 in face amount of Onondaga's first mortgage bonds which were in default and, when convinced that Onondaga could no longer operate with profit, through a wholly controlled dummy, Domark, caused a foreclosure of the mortgage and on a foreclosure sale bought in all the mortgaged property for $25,000.

Upon the adjudication of Onondaga the appellant had a claim of undisputed validity in the amount of $616,233.23. The trustee in bankruptcy brought an action in the New York State Supreme Court against the appellant based upon a claim that its acquisition, through the foreclosure sale, of Onondaga's mortgaged property constituted an illegal preference and a fraudulent conveyance. The trial court dismissed his complaint on motion, and its judgment was affirmed by the Appellate Division. The New York Court of Appeals, however, reversed on the ground that there was enough evidence in the case to afford an inference that acquisition by the appellant of the bankrupt's assets constituted an illegal preference or a fraudulent transfer. The trustee prevailed in the trial court on the second run. The Appellate Division affirmed the judgment of the trial court except as to damages: it directed a judgment in favor of the trustee in the amount of $55,000 which it found to represent the full market value of the trans-

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ferred assets ($54,850), less the amount paid by appellant at the foreclosure proceeding ($25,000), plus interest on the difference ($21,551.70), plus costs of $1,946.95, the judgment also providing for additional interest to be computed to date of payment. 277 App. Div. 1090. This judgment was affirmed by the New York Court of Appeals, 302 N. Y. 932, 100 N. E. 2d 189, and was promptly paid to the trustee by the appellant.

The question presented is whether the appellant is entitled in the Bankruptcy Court to share on a parity with other unsecured creditors in a fund made available for distribution only after a successful showing by the trustee in the state-court action that the appellant was the recipient of an illegal preference or fraudulent transfer of the bankrupt's property.

The referee and the court below held that a bankruptcy court is a court of equity with the power to subordinate claims in cases of this type. Appellant's claim was subordinated on the theory that as a transferee of a fraudulent conveyance it is not entitled to share equally with other creditors on general equitable principles.

We think that Section 57g of the Bankruptcy Act applies here. Under that sectoin, "the claims of creditors who have received or acquired preferences, conveyances, transfers, assignments, encumbrances, void or voidable under this Act, shall not be allowed unless such creditor shall surrender such preference" etc.

We hold that the Bankruptcy Court was without power in the circumstances of this case, to order the subordination of the appellant's claim. Section 57g was designed to insure equality of distribution of the bankrupt's assets,

not exempted under the Act, amongst its creditors: it was not designed to punish a creditor who had sought to withhold the debtor's assets from the bankruptcy estate. If a creditor having a valid common claim free from equitable infirmities, in an effort to obtain satisfaction of his claim or security therefor, accepts a conveyance of assets of his debtor—later the bankrupt—with actual intent thereby to defraud the debtor's other creditors, nevertheless, if after adjudication he surrenders the assets thus acquired to the court, he may share on a parity with other creditors. And it makes no difference that the surrender is the result of a successful action instituted by the trustee against the creditor: Section 57g *does not distinguish between voluntary and involuntary surrender. Keppel* v. *Tiffin Savings Bank*, 197 U. S. 356, *Page* v. *Rogers*, 1909 211 U. S. 575. In the *Keppel* case the Court, so far as here relevant, was faced with the same language as it found in the present Section 57g, and its doctrine has been frequently followed. *Wells* v. *Lincoln*, 1914 9 Cir., 214 F. 227, *Boylston National Bank* v. *Wainhouse*, 1926 1 Cir., 14 F. 2d 385, *Barks* v. *Klegne*, 1926, 9 Cir., 15 F. 2d 153, *In re Cook*, N. D. Georgia, 1924 298 F. 125, *Winkleman* v. *Ogami*, 1941 9 Cir., 123 F. 2d 78, *Irving Trust Co.* v. *Frimitt*, 1932 1 F. Supp. 16, *In re George M. Hill Co.*, 3 Cir., 130 F. 315, 1904 *In re Clark*, 1910 D. C. N. Y., 176 F. 955. Cases governed by the Bankruptcy Acts of 1867 and 1874, must be distinguished, 3 Collier on Bankruptcy, p. 241.

As the cases above-cited show, whether the transaction which was litigated in the state court was an illegal preference is not material under Section 57g. It is true that some cases seem to suggest that participation by a creditor in a fraudulent transfer, as distinguished from an il-

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legal preference, may require the subordination or disallowance of the creditor's valid claim. See *Union Central Life Insurance Co.* v. *Drake*, 8 Cir., 214 F. 536. *In re Oppenheimer*, N. D. Iowa, 140 F. 51. See also *In re Sherk*, N. D. Ohio, 108 F. Supp. 144, which held, without reference to any authority, that 57g makes a distinction between voluntary and involuntary surrender. We think that these cases erroneously interpret 57g and the *Keppel* case which was cited with approval by the Supreme Court as recently as 1944. *Stewart & Bros., Inc.* v. *Bowles*, 332 U. S. 398, 404. Moreover, Section 57n of the Bankruptcy Act, without any distinction between preferences and fraudulent transfers, allows a creditor to file his claim within 30 days after the recovery or avoidance by the trustee. See also *Dabney* v. *Chase National Bank*, 2 Cir., 196 F. 2d 668, 673.

We think it not reasonable to assume that *Pepper* v. *Litton*, 1939 308 U. S. 295 and *Sampsell* v. *Imperial Paper Corp.*, 1941, 313 U. S. 215, on which the court below relied, overruled, *sub silentio*, the *Page* and *Keppel* cases, especially in view of the long line of cases cited above which followed their doctrine. The issues in the *Pepper* and *Sampsell* cases did not involve Section 57g and that section of the Act is nowhere referred to in those decisions. These were cases in which the creditors' underlying claims were subject to equitable defenses: the decisions turned on that factor.

We do not think it of any consequence that the state-court action as originally instituted purported to be brought solely for creditors other than appellant and that the judgment in the state court was for money damages instead of recovery of the bankrupt's assets in kind. The

trustee's power is determined under the Bankruptcy Act. As so measured, the trustee, in seeking to recover assets of the estate, acts for all creditors and lacks power to exclude any from the benefit of a successful endeavor. Certainly the thrust of Section 57g may not be avoided by a misconception on the part of a trustee as to his duties and powers. The case would be different if the trustee in the state-court action had not fully recovered the assets or the value thereof from the transferee-creditor. This is not such a case.

Reversed.

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DISTRICT JUDGE'S DECISION.

The petitions to review herein challenge the legality of the order of the Referee, dated August 25, 1953, which in effect holds that the claims of the First Trust and Deposit Company and Domark Corporation, in the amount of $616,233.23, are valid claims against this bankrupt estate, and subordinates such claims in the matter of dividend payments thereon to all other unsecured claims, filed and allowed in the amount of $201,201.46. The Referee made a written decision herein, supplemented by findings of fact and conclusions of law.

The proceedings in the matter of the administration of this bankrupt's estate have been subject to an unusual amount of litigation, and have extended over a period since about 1940. The matter of the distribution of assets recovered by the trustee and in his hands remains to be accomplished. In the process of determining the matter of the distribution of dividends, differences of opinion or difficulties arose. The petitioner, First Bank and Trust Company, by a written notice asserted the right to share in such dividends pro rata with other creditors. The trustee sought a determination, and the procedure involved therein came before this court upon a review of the Referee's order in March, 1952. In denying that petition, this Court wrote an opinion dated May 7, 1952, which outlined the essential facts, which will not be repeated here. References to such facts are also contained in the Referee's decision of the present controversy, and in his findings of fact relating thereto. Lengthy briefs have been filed, and exhibits consisting of the records on appeal and the briefs filed in the state court litigation are before the Court, and have been the subject of examination and consideration.

The trustee holds in his possession the sum of about $55,000, paid to him by the petitioner, First Bank and Trust Company, on July 11, 1951, by reason of a judgment obtained by the trustee against said petitioner in a state court action. The details of that litigation are unnecessary, except to state that the judgment above mentioned resulted from findings to the effect that the transfer of assets by the bankrupt to the Domark Corporation, (whose claim is now owned by the First Bank and Trust Company), was made through a foreclosure proceeding which was sponsored by the Bank, and in legal effect amounted to action on its part to hinder, delay and defraud the creditors of the bankrupt.

The petitioners claim here that the money recovery made in the state court action was for the benefit of all creditors, and that both legal and equitable principles require the distribution of same pro rata among all creditors, including the Bank.

It is the trustee's contention that the state court action was brought, tried and decided upon the theory that it was for the benefit of creditors other than the First Bank and Domark, who were defendants in the action; and, further, that the Bank should not be allowed to share equally with other creditors in the proceeds of an action brought against it to recover an account of its wrong doing.

There is no doubt but that the action was brought and tried upon the theory that the recovery would be for the benefit of creditors, exclusive of the First Bank and Domark. The pleadings, the briefs, the trial Judge's findings, conclusions and opinion, all lead to that conclu-

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sion. The money judgment rendered by the trial court represented the proportionate amount that the claims of creditors other than the First Bank and Domark bore to the total going concern value of the assets transferred. Upon appeal the Appellate Division held that the market value rather than the going concern value was the correct measure of damages, and expressly reversed the findings of the trial court wherein the value of the assets were found, and substituted findings which in effect reduced the value of such assets to approximately $54,000. The appellate court then struck from the judgment of the trial court the computation made, as above set forth, and substituted therefor a conclusion which provided for a judgment in favor of the trustee for the full market value of the assets transferred. Although it is not discussed in the opinion of the Appellate Division, it seems plain that the appellate court followed the rule to the effect that, if a conveyance of property is declared invalid in the suit of the trustee at the behest of one creditor, the benefit inures to all, and that it should not concern itself with the matter of the distribution of the proceeds of the suit. (Moore v. Bay, 284 U. S. 4; Buffum v. Peter Barceloux Co., 289 U. S. 227; Collier on Bankruptcy, 14th Ed., Vol. 4, Sec. 70.95, and cases cited. See discussion In Re Rogal, 112 F. Sup 712 at 716).

It is true that this action was brought to recover damages, rather than to compel the return of the transferred assets, but the Court sees no reason why the action should be exempted from the general rules stated above.

The power of the Bankruptcy Court in the matter of the distribution of dividends was discussed in this Court's opinion of May 7, 1952, above referred to, viz: "It is now

beyond question that bankruptcy courts have the equitable power to subordinate claims or dividends thereon to those of the same class in accordance with equitable principles. The case of Local Loan Company v. Hunt, 292 U. S. 234, is frequently cited as the authority for the defining of equitable powers in courts of bankruptcy. The use of such powers appears to have been stimulated by the decision in *Pepper* v. *Litton*, 308 U. S. 295, and the Supreme Court has directly recognized same in such cases as *Sampsell* v. *Imperial Paper Corporation*, 313 U. S. 215 at 219, and *Prudence Corp.* v. *Giest*, 316 U. S. 89 at 93. The principle is recognized without exception by the lower courts in numerous reported decisions."

The Bank and the truste have litigated the issue as to the validity of the procedure used in transferring the assets of the bankrupt to Domark. It was found that petitioner's actions in and relative to such transfer were intended to hinder, delay and defraud creditors of the bankrupt, as such intent is presumed in the law, and as distinguished from actual intent. Litigation over that question may not be renewed here. (Heiser v. Woodruff, 327 U. S. 726).

The question then is narrowed to determine whether or not the Referee has abused his equitable powers, in determining that a creditor, who by his actions has hindered, delayed and defrauded other creditors to their prejudice and disadvantage, should not share equally in the assets of the estate the value of which he was compelled by legal action to restore. The mere posing of the question would seem to be a sufficient answer. The application of equitable principles is not to be rigidly confined. Here we have interlocking directorships and control among the

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Bank, Domark and the bankrupt. In fact, it does not seem to be disputed but that the bankrupt was controlled by the Bank and that Domark was in effect the Bank. Such a situation requires rigid adherance to the rules of fair play. Here also we have a sale of assets for something less than one-half their market value, and the purchase of same by the Bank. One only needs to read the decision in Pepper v. Litton, supra, from 306 to 312 to conclude that the equity power of the court was properly invoked. The violation of the rules of fair play and good conscience, the lack of inherent fairness or the non-existence of an arm's length bargaining are tests which bring the equitable power of the Court into action. Here we also have the individual advantage or profit accruing to the bank to the detriment of the creditors as the result of a planned program. Under such conditions "—the necessity of equitable relief against that fraud becomes insistent." (Pepper v. Litton, supra, at page 312). That all judges hearing the case did not agree may be a circumstance to be considered, but is by no means controlling; neither is the history of the bankrupt's financial dealings with the Bank, which appear in detail in the record and in the briefs. The Bank here in effect sought to obtain for its ultimate benefit all of the assets of the bankrupt. After years of expensive litigation that result has been thwarted. Equity would seem to protest that the Bank should share the benefits equally with the creditors whom it attempted to defraud. This Court can find no violation of the application of equitable principles by the Referee and, no contention having been raised as to the validity of the claims now held by the Bank, his order is affirmed.

ORDERED, that the order of the Referee, dated August 25, 1953, in effect finding certain claims now held by

the petitioner, the First Trust and Deposit Company to be valid clamis, and subordinating same in dividend payments to all other claims in the sum of $201,210.46, is affirmed, and the petitions to review are dismissed.

STEPHEN W. BRENNAN
U. S. D. J.

REFEREE'S DECISION.

This matter comes before this Court for determination by reason of its notice to all creditors of the Onondaga Litholite Company dated June 5, 1952 returnable before this Court at Syracuse, New York on June 24, 1952. The notice was addressed primarily to creditor First Trust and Deposit Company to determine whether its claim of $616,233.23 duly filed should be excluded from participation in dividend to be declared from the funds presently in the hands of the trustee in the sum of approximately $55,000.

This Court feels that a review of all of the details of this matter which has been in the Court since July 17, 1939 can serve no useful purpose.

The basic question for this Court's determination is whether claimant First Trust and Deposit Company, unsecured creditor, should in equity be excluded from participation in the dividend to be distributed to general unsecured creditors or subordinated in payment to certain creditors in whose behalf a certain action was brought by the trustee against the said creditor, First Trust and Deposit Company.

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In the beginning, it should be clearly noted that the jurisdiction to allow or disallow claims is based on Section 2(a) (2) (7) of the Bankruptcy Act and the Court's jurisdiction in this respect is exclusive of all other Courts.

Further, in passing on an allowance of claims, the Court sits as a court of equity, which gives it far reaching powers "to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate."

In view of the equitable powers of the Bankruptcy Court and particularly in view of the provisions of Section 57(k) of the Bankruptcy Act, a claim against a bankrupt estate may be disallowed or subordinated to other claims in the light of equitable considerations. (Pepper vs. Litton, 41 ABR (NS) 279.)

It appears that on July 17, 1939, the Onondaga Litholite Company was adjudicated a bankrupt and trustee was duly appointed. Thereafter on November 29, 1940, the trustee was authorized and directed to commence an action against creditor First Trust and Deposit Company, its officers and directors, and also Domark Corporation, to recover damage to the remaining creditors on account of certain alleged invalid transfers of the bankrupt's assets to the said creditors above-named.

Claims of creditors other than First Trust and Deposit Company and Domark Corporation numbered about forty-eight for a total of about $201,210.46.

This equity court in its effort to sift the circumstances surrounding any claim to see that no injustice or unfairness is done must of necessity go to the record of the

former legal proceedings and judicial determinations of the State Courts in which these issues were tried and determined, to ascertain if the circumstances surrounding the claims of the First Trust & Deposit Company and the Domark Corporation are such that in equity they should be excluded from dividend participation or subordinated in payment to all other claims in this estate.

With this thought in mind, it is interesting to note the language of the Court of Appeals in 293 N. Y. 604 wherein it reversed the Appellate Division (266 A. D. 1056) and sent this issue back to the Supreme Court for trial. It said in substance,

> "In our judgment, the evidence affords room for an inference of actual intent of defendants to hinder the unsecured creditors of the company in the realization of their respective claims, and also gives countenances to an inference of consequent prejudice to such claimants through the bank's acquisition of the company's property at a minor fraction of its market value."

It does further appear that creditors-defendants, First Trust and Deposit Company and Domark Corporation were put on definite notice in the plaintiff's Bill of Particulars, dated December 9, 1941, furnished to them pursuant to their demand and court order (Particular # 9) that "due to conveyance of practically all of bankrupt's assets to First Trust and Deposit Company as alleged in plaintiff's complaint, all the creditors of the bankrupt, except First Trust and Deposit Company and Domark Corporation have sustained damage to the extent of their claims against the bankrupt which remain unpaid."

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From this Particular # 9, there could be no question in defendant's mind for whose benefit this action was brought and which creditors of the bankrupt were damaged by their action.

Further search for where the equities must lie as between the bankrupt's creditors, it appears clearly in the Findings of Fact and Conclusions of Law found by Supreme Court Judge Joseph A. Wechter dated August 13, 1949, specifically referring to his conclusions of law (1) "The foreclosure and sale of bankrupt's assets was commenced and consummated for the purpose presumed in law of transferring the real property—and other described property to defendants First Trust and Deposit Company and Domark Corporation, to hinder, delay and defraud other creditors of the bankrupt".

There is further language in the Court's Conclusions of Law as follows, "By reason of such illegal transfer, creditors of the bankrupt have been unable to collect any part of their claims and have suffered damage as a result in the amount of their claims, to wit, $201,210.46", and further "the foreclosure sale constituted a concerted action on the part of defendants—to place bankrupt's property in the hands of defendants for the purpose of securing bankrupt's debts to the exclusion and disadvantage of other creditors of bankrupt", further "to the prejudice and disadvantage of other creditors of bankrupt", and, "while insolvent for the purpose of preferring First Trust and Deposit Company over other creditors of the bankrupt", and Conclusion # 14, "That plaintiff should be awarded judgment against defendants in the sum of $201,210.46 with interest from August 1, 1938."

Further in the memorandum of Honorable Joseph A. Wechter, Supreme Court Judge dated August 13, 1949, we find the following language, "The question remains, what damage was suffered by and should be awarded to those represented by the plaintiff trustee in bankruptcy in this action, the petitioning creditors in bankruptcy and the other creditors exclusive of defendants First Trust and Deposit Company and the Domark Corporation" and, "I find that the claims of creditors so represented by this plaintiff in this action had a value immediately prior to the termination of the company as a going concern of $60,000 which was wiped out by the wrongful conduct and that said creditors suffered damage in that amount as of shortly prior to August 1, 1938 and that such creditors are entitled to interest thereon as damages ascertainable by computation from August 1, 1938."

Tracing this action further with the same thought in mind, we find the decision of Hon. Joseph A. Wechter, Judge of Supreme Court, appealed and the Appellate Division in (277 A. D. 1090) reversing the Supreme Court's method of computation of damage, holding that the "going concern" theory was in error but adopted "market value" as the correct standard. This method of course reduced the amount of damages due creditors other than the First Trust and Deposit Company and Domark Corporation, but it must be clearly emphasized that the Appellate Division confirmed the judgment of the Supreme Court in all other respects. The decision of the Appellate Division was affirmed in the Court of Appeals without opinion in (302 N. Y. 932).

This Court has diligently searched the exhibits and records upon which this proceeding rests and can find no

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legal findings of fact or conclusions of law, nor even some casual legal expression in the State Court proceeding that would sustain the claimants' contentions (first) that the trustee's action against the First Trust and Deposit Company and Demark Corporation was for the benefit of all of the bankrupt's creditors and, (second) that the action of these claimant creditors was such that in equity they should be entitled to participate in dividend distribution on a parity with all other general unsecured creditors.

Such a decision by this Court would make a sham and a mockery of the clear legal determinations of the State Courts, realized after years of intense legal trial and struggle by several of the most experienced astute legal counsel in this District.

A Bankruptcy Court has full power to inquire into the validity of any claim asserted against the estate and to disallow it if it is ascertained to be without lawful existance. (Lesser vs. Gray, 236 U. S. 70) (Pepper vs. Litton, 41 ABR (NS) 289). The mere fact that a claim has been reduced to judgment does not prevent such an inquiry. The merger of a claim into a judgment does not change its nature so far as provability is concerned, (Boynton vs. Ball, 121 U. S. 457). The Court may look behind the judgment to determine the essential nature of the liability for purposes of proof and allowance (Wetmore vs. Markov, 196 U. S. 68). It may ascertain the validity of liens, marshal them and control their enforcement and liquidation, (Isaacs vs. Hobbs, 282 U. S. 734), (Pepper vs. Litton, 41 ABR (NS) 290.)

With this legal authority in this Court and a careful review of the records of the trials of this issue in the courts

of the State of New York, upon which the claimants claim is submitted, this Court can come to but one conclusion and it does so find that the claims of the First Trust and Deposit Company and Domark Corporation in the face amount of $616,233.23 are valid claims against this bankrupt estate but in the matter of participation in the distribution of the funds presently in the hands of the trustee for final closing distribution, they shall be subordinate in dividend payment to all other claims duly filed and allowed in the sum of approximately $201,210.46.

ORDERED accordingly.
Dated at Utica, New York

August 12, 1953.

DAVID J. GOLDSTEIN,
U. S. Referee in Bankruptcy.

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OPINION OF TRIAL COURT IN STATE ACTION.

SUPREME COURT—Onondaga County.

George A. Langan, as Trustee of Onondaga Litholite Company, Bankrupt,
Plaintiff-Appellant-Respondent,
-against-
First Trust & Deposit Company, Richard F. Harrison, C. Harry Sandford, Albert B. Merrill, Joseph P. Rogers and Donald H. Yeomans,
Defendants-Respondents-Appellants,
and
Domark Corporation, Jacob B. Sehl, W. Paul Eddy and George F. Broga,
Defendants.

Appearances:

Messrs. Smith, Sovik, Levine and Richardson, attorneys for plaintiff; Laurence Sovik, Esq., of Counsel.

Messrs. Hiscock, Cowie, Bruce, Lee and Mawhiney, attorneys for defendants First Trust & Deposit Company, Richard F. Harrison, C. Harry Sandford, Albert B. Merrill, Joseph P. Rogers and Donald H. Yeomans; H. Duane Bruce, Esq., and Phillip T. Young, Esq., of Counsel.

Messrs. Hancock, Dorr, Ryan and Shove, attorneys for deceased defendant Jacob B. Sehl; Jerome H. Searl, Esq., of Counsel.

Lawson Barnes, Esq., attorney for defendant Domark Corporation.

Ephraim J. Paige, Esq., attorney for defendants W. Paul Eddy and George F. Broga.

WECHTER, J.

Throughout I shall adopt the Court of Appeals abbreviations of Company to designate Onondaga Litholite Company and Bank to designate First Trust & Deposit Company.

March 1, 1941, is the date of issue in this action. The first trial resulted in a decision of March 1, 1943, dismissing the complaint at the close of the plaintiff's case upon the ground that plaintiff failed to establish by competent proof any of the causes of action (seven are pleaded) alleged in the complaint, or any other cause of action against any of the defendants by reason of violation of statutes or other illegal acts upon the part of them or any of them. This decision was upheld by a divided Appellate Division (266 App. Div. 1056) and the Court of Appeals reversed the judgments entered on such affirmance (293 N. Y. 604) remanding the causes for new trial.

The then defendant Jacob B. Sehl entered a separate judgment of dismissal at the close of the first trial and while the appeal therefrom (March 22, 1943) was pending (argued September 23, 1943) and on September 20, 1943, he died, and on November 10, 1943, the Appellate Division affirmed the "four judgments," one of which was Sehl's. No judgment was entered on such affirmance of said judgment, no appeal was attempted therefrom and no appearance for his estate, heirs or next of kin has been made. The action as to Sehl has become severed and an order to that effect may be entered, the original judgment

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of dismissal as to him being still the law of this case as to him.

Interim the judgment entered upon the determination by the Court of Appeals and the trial of October last, the plaintiff served demands under Sections 322 and 322-a C. P. A. upon the defendants W. Paul Eddy and George F. Broga for the admission of the truth or genuineness of 156 items; upon the defendants First Trust & Deposit Company, Richard F. Harrison, C. Harry Sandford, Albert B. Merrill, Joseph P. Rogers and Donald H. Yeomans for the admission of truth or genuineness of a like list; upon the defendant Domark Corperation for the admission of the truth or genuineness of a like list. A motion to vacate the demands was granted but on appeal was reversed (270 A. D. 700, affirmed 296 N. Y. 1014) and the demands in effect reinstated.

Replies were then served to such demands varying from admissions as demanded through partial admissions and explanatory statements, to denials or refusals on grounds stated, and these were presented on trial. Many admissions of questions (still at issue under this exchange of papers) were made on the trial. No questions remained at the close of the trial, as to expenses incurred by the plaintiff to prove the genuineness of material papers, lack of reasonableness of refusals; expenses incurred by the plaintiff in proving facts where admission was not stated, or of lack of reasonableness of refusal, and the Court finds that no case has been established for any award resultingly.

To limit what may follow, and to avoid by anticipation any misunderstanding thereof, the Court finds that there was no sufficient competent evidence to establish on the

part of defendants or of any defendant actual intent, as distinguished from intent presumed in law, to hinder, delay or defraud either then present or future creditors, within the meaning of Sections 276 and 276-a of the Debtor and Creditor Law. Such result to other creditors may have been a natural, probable or in fact inevitable (and therefore foreseeable) consequence of the course of conduct of defendants, but it was not a motive born of malice inducing the conduct; and the issue narrows down to whether the defendants or some of them misconceived the extent of loyalty, deemed primary by them, that they should discharge to the Bank and became so blinded as to ignore the duties of director or trust relation to the Company and its non-Bank directors.

The second trial consumed the last ten court days of October, 1948, and the testimony is voluminous, including substantially the entire record of the first trial, the exhibits are numerous and frequently extensive; resultingly counsel's submission by briefs and by answering and reply briefs, with proposed findings was not accomplished until mid-April since which time until July 1st, this Court has sat in continuous assignment. It is therefore (notwithstanding the time elapsed) with reasonable promptness that the Court approaches the determination of the merits.

I have prepared a diagram of the personalities involved in the defence showing by columns their respective connection with the Company as stockholders, officers or directors including membership on the Executive Committee as well as their connection with the Bank as officers, directors or attorneys.

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Persons Named	Board Co.	Served Dates	Co. Board 2-11-37 11-19-38	Co. Board 11-19-38 6-30-39	Co. Ex. Com. 2-11-37 6-30-39	Co. Stock-holders	Bank Directors	Domark & Bank Attys.	Bank Owned	Attys. for
1. First Trust & Deposit Co.										
2. Domark Corporation										
3. Richard F. Harrison	Ex. Committee	2-11-37 6-30-39			x	x	x		x	
4. C. Harry Sandford	Director, Ex. Committee	2-11-37; 11-19-38 6-30-39	x		x		Officer			
5. Albert B. Merrill	Ex. Committee	2-11-37 6-30-39			x		x			
6. Jacob Sehl	Director, Ex. Committee	2-11-37; 11-19-38 6-30-39	x		x	x				
7. W. Paul Eddy	Director, Pres. Ex. Committee	2-11-37 6-30-39	x	x	x	x				
8. Joseph P. Rogers (H. C. B. & L.)	Director	2-11-37 6-30-39	x	x				x		
9. George F. Broga	Director	2-11-37 6-30-39	x	x		x				
10. Donald H. Yeomans (H. C. B. & L.)	Director	2-11-37 6-30-39	x	x				x		
Hiscock, Cowie, Bruce & Lee								x		x

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In this diagram I have listed Domark as Bank owned. Here again as a preliminary and to limit what may follow to avoid by anticipation any misunderstanding thereof the Court finds:

(a) Defendants C. Harry Sandford, Jacob B. Sehl, W. Paul Eddy, Joseph P. Rogers, George F. Broga and Donald H. Yeomans were duly elected Directors of Onondaga Litholite Company and acted as such for the times respectively alleged in the complaint as to each.

(b) The defendants, Richard F. Harrison, C. Harry Sandford, Albert B. Mer.ill, W. Paul Eddy and George F. Broga were duly selected and appointed Executive Committee of Onondaga Litholite Company and its Board of Directors and accepted and acted in such capacity for the times and terms respectively alleged as to each in the complaint.

(c) Domark Corporation in its conception, birth and throughout its life at all times involved in this litigation was the creature of the defendant Bank constituting for practical purposes the name of a bookkeeping account of the Bank in the segregation of its assets; for the purpose of these issues defendants First Trust & Deposit Company and Domark Corporation are two names of a single identity: using either name means the Bank.

The proof as tabulated in the diagram shows that the Executive Committee of five had as its majority or working control two directors and an officer of the Bank; that the board of six directors which appointed this Executive Committee found three of its membership in a Bank Of-

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ficer and two attorneys for the Bank who also acted as attorneys for the Company; and a fourth member, Sehl, was an accountant regularly used by the Bank; further that a voting trust agreement made possible the perpetuation of this control. For the exercise of control of the Company by the Bank the interlocking seems entirely adequate and complete. Under these circumstances the situation of each of the interlocking personnel became delicate indeed. They were men of large affairs. They were men capable of appreciating the dual or multiple positions in which they were placed. The language of Judge Cardozo in Meinhard v. Salmon, 249 N. Y. 458, while forceful is singularly appropos as their rule of conduct under these circumstances: "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilo of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion,' of particular exceptions. (Wendt v. Fischer, 243 N. Y. 439, 444.) Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this Court." And this standard as enunciated by the Chief Justice was reiterated by him in another capacity in a state of facts not too unlike those presented here presenting a question of intra-corporate duty. (Buckam, as Trustee, v. Peter Barceloux Co., 289 U. S. 227.)

We have indicated the standard to be used as a measuring stick. What are the facts to which it is to be applied?

The bankrupt had prospered for some thirty years and for a score of those years had built up a successful business in casting made stone to pattern in marble and granite, including fine ornamental work. Its business was nation wide.

In 1929 and thereafter the well-nigh universal depression in construction work affected the Company and it showed operating losses although cash losses were not sustained until 1933. In 1932, its cash profit was shown as $23,547.00.

As will appear, the business ended in the first half of 1938 and the cash losses from 1933 through 1937 were large and included payments of interest to the Bank of approximately $52,000.00. Coincidentally at least, the nation wide (and world wide) business slump, the Bank management of the Company, and the first period of business losses in the latter's history were contemporaneous.

On February 11, 1937, the Bank secured the voting trust which it controlled and thereupon the Board of Directors which we have analyzed was placed in power and Executive Committee which we have analyzed managed the business.

The Bank owned the first bonds secured by mortgage with the exception of one of the value of $100.00, and additionally held the Company's paper for over $330,000.00, as well as its unsecured B Bonds to the amount of $105,000.00.

By July, 1938, the borrowings from the Bank had increased about $168,000.00.

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Late in 1936, the Bank caused a survey to be made of the Company's business and then decided that there was a fair prospect of recouping losses by continuation of operation.

During these periods the Salt Springs National Bank held $105,000.00 in B Bonds of the Company, the general public held about $164,000.00 and the general creditors a very considerable aggregate, all unsecured.

The Bank having determined from the 1936 survey to continue the Company in operation and having implemented that decision by the voting trust and business control of February, 1937, purchased additional machinery in 1937 and in 1938 and in the first months of 1938 showed a business increase of $15,000.00 in February and $56,000.00 in March, at which time determination was reached to terminate the business with the completion of its then back-log of orders.

This determination was promptly followed by a transfer of all of the mortgaged assets of the Company to the Domark Corporation, which means to the Bank. The non-mortgaged assets of the Company were already assigned to the Bank as collateral to the non-mortgaged debt to the Bank.

The transfer of the mortgaged assets was not made by conveyance but by an ostensible foreclosure of the mortgage by the Trustee on the demand of the Bank. The foreclosure was in no way brought to the notice of the stockholders or creditors (other than the Bank) of the Company and the Company's directors became parties to a collusive arrangement. By this collusive arrangement they permitted their

first loyalty to the Bank to cause an action to be brought against the Company of which they were directors without an opportunity to the real parties in interest, the stockholders and creditors, to have notice thereof, to have a day in court, to avoid mortgage default, or to redeem or to plan a future for the Company to protect their interests. The foreclosure was a transparent use of legal machinery with a gossamere-thin appearance of regularity but without opportunity of any kind to the real parties in interest (to whom they owed a fiduciary obligation) to protect themselves. In this the directors not only failed affirmatively to protect those to whom they owed a duty but became parties to a program in the nature of a conspiracy of silence and concealment which caused serious damage.

By these means the Bank through a controlled Board of Directors and a controlled Executive Committee secured for a consideration of $25,000.00, the mortgaged assets of the Company which were worth much more.

This constitutes something other than a mere preference. There was a plan for an ostensible legal sale so brought about that other creditors would not learn of it and this is confirmed by the failure to encourage interest on the part of casual inquiries as indicated by the correspondence. Such an attitude either avoided or forestalled other bids. The entire foreclosure and transfer by Referee had no greater effect or validity than a direct conveyance by officers of the Company thereto empowered by this controlled Board of Directors, to the Domark Corporation. In this I am not impugning the good faith of the directors in their asserted determination in early 1938 that the Company should not continue operations. That was a debatable question. There was probably reasonable ground for either side on that

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question. But having determined it, the directors were bound to implement their determination equally and equitably for all those whom they were chosen to represent and they were not justified in acknowledging and obeying a single loyalty to the Bank to the exclusion of others. That conduct violated also the provisions of the General Corporation Law and the Stock Corporation Law.

The question remains, what damage was suffered by and should be awarded to those represented by the plaintiff Trustee in Bankruptcy in this action, the petitioning creditors in Bankruptcy and the other creditors exclusive of defendants First Trust & Deposit Company and Domark Corporation.

They were proportionately damaged by that sum constituting the difference in value of their claims collectively against the Company as a going concern and the value of their claims as realized, to wit, nothing.

The value of unsecured creditors' claims against the Company as a going concern was that proportion of their face, which the total of unsecured creditors' claims bore to the assets of the Company after deducting the amount of secured claims.

I find that the claims of creditors so represented by this plaintiff in this action had a value immediately prior to the termination of the Company as a going concern of $60,000.00 which was wiped out by the wrongful conduct and that said creditors suffered damage in that amount as of shortly prior to August 1st, 1938, and that such creditors are entitled to interest thereon as damages ascertainable by computation from August 1st, 1938.

Enter judgment accordingly in form agreed upon by counsel or on settlement by the Court on five days notice. Dated, August 13, 1949.

JOSEPH A. WECHTER,
J. S. C.

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